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EUROPEAN UNION BALANCE OF PAYMENTS ASSISTANCE

LATVIA

EC STAFF REPORT FROM THE 4TH REVIEW MISSION TO RIGA
(LINKED TO THE 5TH INSTALMENT)

Executive summary

The Commission services carried out the fourth review mission in cooperation with the IMF staff from 5 - 15 April 2011 to assess progress made with respect to the specific conditions laid down in the third Supplemental Memorandum of Understanding (SMoU).[1] Based on the findings of the mission and a Compliance Note sent by the authorities on 1 April 2011, the specific economic policy criteria are considered to be broadly fulfilled. Since the previous review mission, further budgetary and structural measures, supported by an improved macroeconomic outlook (the economy bottomed out in 2010 and GDP is expected to expand by 3.3% in 2011 and 4% in 2012), **ensured compliance with the policy programme**. In particular, this conclusion reflects:

a) **Achievement of the 2010 budget deficit target of max. 8.5% of GDP in ESA95 terms**: the fiscal deficit was 7.7% of GDP, or, excluding bank restructuring costs, 5.5% of GDP.

b) **Parliamentary adoption of the 2011 budget on 21 December 2010 and a supplementary 2011 budget on 14 April** with total measures amounting to around LVL 370 million in full year impact, according to the estimates by the authorities (around 2.8% of GDP, though not all of these will yield permanent savings). This should be sufficient to achieve the 2011 deficit target of well below 6% of GDP, with the Commission services' spring 2011 forecast expectation of a deficit of 4.5% of GDP in 2011.

c) **Progress being made as concerns the strengthening of the fiscal framework, though at a slower pace than expected**. The authorities intend to agree with the EC/IMF on the substance of the draft fiscal responsibility law by end-August 2011 and to submit the draft law(s) to Parliament by end-November 2011, as well as prepare the draft medium-term budget framework law, to be submitted to Parliament by mid-2012. The authorities continue working on amendments to the constitution to ensure that provisions of the fiscal responsibility law have greater legal standing than other laws.

d) **Progress being made with strengthening tax administration and combating the grey economy**. In the 2011 budget and its supplement the authorities have introduced: (i) measures to speed payment of tax arrears; (ii) an increase in the minimum wage, which should limit the underreporting of wages (despite risks of adverse effects on employment); (iii) steps to combat smuggling of goods; and (iv) an approach to improve cooperation with sectoral business associations.

e) **Significant financial system stabilisation measures having been taken**, including on management of large exposures, remuneration policies, and stress testing guidelines, while cooperation continues with neighbouring countries and relevant foreign supervisors. The work-out/sales strategies of the Parex Bank and Citadele banks were agreed by the Cabinet of Ministers in May, and the transformation plan of the Mortgage and Land Bank has been finally submitted to the European Commission on 15 April.

f) **Good progress in addressing structural reforms**, in particular as regards improving absorption of EU funds, amending public procurement procedures, streamlining efforts to attract new FDI and making operational the special programme for the support of small and micro companies.

The Latvian authorities are not requesting disbursement of the fifth instalment nor of the remaining funding under the programme, though the possibility to ask for disbursement, if the

[1] The mission met with Prime Minister Dombrovskis; Finance Minister Vilks; the Bank of Latvia Governor Rimšēvičs; Head of the Financial and Capital Market Commission Krūmane; senior officials in these institutions; coalition and opposition political parties; mayors; social partners including the trade unions, the employer's confederation and the chamber of commerce; the foreign investors council; Delna (Transparency International); foreign ambassadors; media; and financial institution representatives.

need arises, is envisaged in the SMoU (concerning the 5th payment a window for requesting is open until 15 June). However, this will neither affect the need to comply with conditionality nor the continuation of the review missions. The authorities are planning to approach international markets during 2011.

Given the progress in stabilizing the financial sector, **modalities have been agreed on a stage-wise approach to unfreezing the approximately EUR 650m in blocked funds** for potential financial sector costs (established in July 2009, EUR 600m are from the EU and around EUR 50m from the IMF). The first EUR 300m are to be released in the summer months, following the government's 15 April submission to the European Commission of the Mortgage and Land Bank's (MLB) restructuring plan, as well as the Cabinet of Ministers decisions on the work-out and sales strategies for Parex and Citadele banks.

Fulfilment of the specific conditions for a possible next and final instalment, if requested, will be assessed at the next Review expected on or after 15 November 2011.

Concerning budgetary consolidation, the authorities are committed to achieving a fiscal deficit of below 3% of GDP in ESA95 terms in 2012 in line with the ECOFIN Council EDP recommendations, while aiming for a 2.5% of GDP deficit in 2012 to ensure a sufficient safety margin. Building on the overachievement of previous fiscal targets and assuming implementation of the 2011 budget, preliminary estimates suggest that achieving this target will require a further LVL 150-180m (1.1%-1.3% of GDP) in net additional measures (well below previous estimates). A menu of consolidation options will be presented to the EC and IMF in mid-August, so as to ensure a timely submission of the budget to the Parliament.

The authorities have completed a concept paper on social security that will form the basis for a comprehensive pension reform to be introduced with the 2012 budget and to take effect in 2016. The authorities are committed to preserving the sustainability of the three pillars of the pension system and to **restoring contributions to the second pillar to 6% of gross salaries by 2013**, provided that the budgetary situation improves in line with the current forecast. Also, the authorities are committed to submitting to the EC/IMF by end-August **proposals for the reform of scope and financing of a comprehensive and targeted social safety net programme for 2012 and beyond**, including improvements in the administration of Social Safety Net Strategy (e.g., setting-up a centralized social assistance register). Definition of the strategy is important, given that the World Bank's Latvia programme comes to an end in the coming months.

There are a significant number of commitments on the structural side in the new SMoU, which are essential to achieve high and sustainable growth. These include actions to remove bottlenecks in EU funds implementation, plans to centralize central and local government procurement, steps to reinforce competition (implementation of Services and Energy directives), principles for better management of state owned assets, improvements in micro companies' support scheme, amendments to the unified wage grid, establishing a single HRM institution for the public sector, further reforms in higher and vocational education, reinforcing capacities of the State Employment Agency, etc.

Overall context

The programme is proceeding well, reflecting further budgetary, financial and structural measures and the improved economic outlook, though risks are present. In particular, the ruling coalition has shown little resolve in deciding and implementing an ambitious structural reform policy agenda. The rapid adoption of the 2011 budget, following October 2010 elections, showed the resolution of the Prime Minister and his new coalition to stick to the Programme commitments. However, the drawn-out process of the supplementary 2011 budget suggests that, looking forward, political difficulties cannot be excluded in view of the 2012 budget, especially on consolidation proposals in social, education and health budgets. In particular, there are still considerable challenges in the fiscal structural field (e.g., tax evasion, illicit trade, management of state-owned enterprises (SOE)), which leaves some risks for continued fiscal discipline after the programme expiration. While there may be positive risks if the economy keeps growing at a fast pace, there are other risks that can have a substantial impact: financial market spill-overs from other economies, a slow-down in export-led recovery, a difficult socio economic situation with unemployment remaining high, etc.

While clear progress is being made on the fiscal front, rising inflation is becoming a possible obstacle to meeting the Maastricht criteria, with a view to adopting the euro in 2014 as envisaged by the Latvian authorities. Hence, fiscal consolidation measures with a positive inflationary effect need to be avoided to the extent possible and the authorities may consider other measures that would counter inflationary pressures in a sustainable manner. Overall, while euro adoption serves as a firm and credible policy anchor, meeting the EDP target and continued fiscal consolidation must be pursued on their own merits. Assessment of fulfilment of the Maastricht criteria will be done in due time, thus the BoP conditionality assessment should not be seen as prejudging it.

Macroeconomic developments

Following a steep contraction of about 25% in 2008-2009, the Latvian economy moved back to positive quarter-on-quarter growth rates in 2010. In annualised terms, GDP marked a small decline of 0.3% in 2010 reflecting the negative carry-over from the previous year. The actual performance in 2010 is however significantly better than the programme scenario from May 2010, which envisaged a GDP decline of 3.5% in 2010, while the previous projections for a strong rebound of 3.3% in 2011 and 4% in 2012 are fully confirmed by the programme scenario agreed in April 2011. The economic recovery is helped by strong demand from all major trade partners and reduced labour costs that have improved the country's competitiveness. As a result, the share of exports in GDP widened to 53% in 2010 from a range of 42% to 48% in the pre-crisis period. Exports are further projected to rise to about 60% of GDP by 2012. However, growth is expected to be more balanced in the future as spillovers from export dynamics start pushing up consumer demand.

		2008	2009	2010	2011	2012
Real GDP growth rate	December 2008 Programme	-4.6	-5.0	-3.0	1.5	n.a.
	Baseline projections, May 2010	**-4.6**	**-18.0**	**-3.5**	**3.3**	**4.0**
	Commission spring forecast (2011)	-4.6	-18.0	-0.3	3.3	4.0.
	Baseline projections, April 2011	**-4.6**	**-18.0**	**-0.3**	**3.3**	**4.0**
HICP inflation	December 2008 Programme	15.5	5.9	2.2	1.3	n.a.
	Baseline projections, May 2010	**15.3**	**3.3**	**-2.0**	**0.0**	**0.5**
	Commission spring forecast (2011)	15.3	3.3	-1.2	3.4	2.0
	Baseline projections, April 2011	**15.3**	**3.3**	**-2.0**	**3.3**	**1.8**
Unemployment rate in % (Eurostat definition)	December 2008 Programme	6.7	9.0	11.0	11.2	n.a.
	Baseline projections, May 2010	**7.8**	**17.3**	**21.0**	**19.2**	**17.9**
	Commission spring forecast (2011)	7.5	17.1	18.7	17.2	15.8
	Baseline projections, April 2011	**7.8**	**17.3**	**18.7**	**17.2**	**15.5**
Current account	December 2008 Programme	-14.8	-7.3	-5.5	-5.5	n.a.
	Baseline projections, May 2010	**n.a**	**n.a**	**n.a**	**n.a**	**n.a**

balance (% of GDP)	Commission spring forecast (2011)	-13.0	+8.6	+3.6	-0.3	-1.6
	Baseline projections, April 2011	**n.a**	**n.a**	**n.a**	**n.a**	**n.a**

Inflation projections increased since the previous review as a result of VAT hikes and adverse external shocks from commodity markets. The Harmonised Index of Consumer Prices (HICP) dropped by an average of 1.2% in 2010 but prices rose rapidly towards the end of the year. Inflation accelerated further to 4.3% year-on-year in April 2011 due to the aforementioned commodity price hikes and one-off effects from increased VAT rates, which include the change in the standard rate to 22% as of January 2011 from 21%, imposition of the standard rate on electricity instead of the previously applied reduced rate, and increasing the reduced VAT rates from 10% to 12%. Inflation pressures are strongly linked to supply side factors while the impact of rising wages is relatively low. In the new baseline scenario, inflation projections (HICP) are revised upwards to 3.3% in 2011 and 1.8% in 2012 with certain risks of further acceleration linked to price fluctuations on commodity markets. However, core inflation projections are relatively low at around 1.8% in 2011 and 2012, which indicates that inflation risks will subside significantly once the effect of commodity prices fades out. In this context, commodity prices remain a major threat to inflation due to the country's high sensitivity to import price shocks, reflecting the small size and high openness of the domestic market, higher share of food and energy in the HICP consumer basket than the EU average, and its high energy intensity. It should be noted, however, that despite the consumer price rebound in 2011, the country's competitiveness in terms of relative unit labour costs is expected to improve in 2011-12 as a result of the projected moderate wage developments.

The labour market is improving at a faster pace than in the previous programme scenarios. However, unemployment remains among the highest in the EU after deteriorating to an all-time high of about 20% in the beginning of 2010 from 6-7% in the pre-crisis period. Towards the end of 2010, the unemployment rate dropped to 16.9%, resulting into a year-average rate of 18.7% (for the age group of 15 to 74 years in accordance with the Eurostat definition). The new programme scenario envisages further decline in unemployment to 17.2% in 2011 and 15.5% in 2012. The recent economic sentiment surveys show favourable employment expectations, implying a positive risk to the labour market forecast. Nevertheless, the labour market will be facing demand and supply mismatches, as a large proportion of the deterioration reflected the downsizing in the construction sector and related industries. Many job seekers will need to change qualifications in order to be employed and therefore the high structural unemployment (around 14% in the Commission estimates) poses significant restraints to the country's potential growth.

The current account (CA) surplus dropped from 8.6% of GDP in 2009 to 3.6% in 2010 and recent developments suggest a reversal to a small deficit in 2011-12. Trade indicators from the beginning of 2011, notably the two-fold increase in car imports in the first quarter of the year, clearly indicate that the ongoing recovery of domestic consumer demand will impact considerably on the CA balance. However, this reversal is not expected to lead to significant external imbalances in the near future as the gap is expected to remain well below the net inflow of foreign direct investments. Moreover, the shift to a CA deficit is largely driven by the primary income flows, where foreign owned companies return to profits, which are booked as outflows in the current account but the underlying retained earnings are simultaneously booked as FDI inflows in the financial account of the balance of payments.

The financial account of the balance of payments had a deficit of LVL 679m (5.3% of GDP) in 2010, down by 66% in relation to a year earlier, reflecting continuous deleveraging in the banking sector. As a result, the private external debt dropped by 1.6% in 2010 to LVL 16.8bn (132% of GDP) at the end of the year. The overall value of the external debt increased by 2.9% to LVL 21bn (165% of GDP) for the same period taking into account the programme disbursements to the government. However, in net terms the country's external debt dropped substantially by 12% to LVL 6.8bn (53% of GDP) due to the build-up of foreign reserves that was also linked to programme disbursements.

Budgetary developments

Considering that (i) **the 2010 budget outcome of 7.7% in ESA95 terms** is below the 8.5% of GDP ceiling and, excluding financial sector costs (about 2.3% of GDP), would be only around 5.5% in ESA terms and (ii) the government has taken a package of measures of about 2.8% of GDP in December 2010 and April 2011 (including measures which will improve the budget, but are not counted against the consolidation needs set for 2011 by the EC/IMF), and (iii) the economy is on a firm recovery path, **there seems to be little doubt that under the current baseline scenario the 6% target for 2011 will be delivered** (the Commission Spring forecasts projects 2011 deficit at 4.5% of GDP). In the context of the 2011 supplementary budget, the authorities have also re-confirmed some important measures, which improve the fiscal outlook: e.g., freezing the indexing of pensions by 2013, suspending the supplementary payments for new pensioners starting in 2012, maintaining caps on maternity, paternity and sickness benefits until end-2012, etc.

Measures in the 2011 budget include, on the revenue side, (i) an increase in both the standard and reduced VAT rates and a reduction of categories for which the reduced VAT regime applies; (ii) higher employees social security contributions, though partly offset by a reduction in the statutory PIT rate and higher PIT allowances; (iii) increased taxation of private vehicles and privately used company cars; (iv) introducing a financial stability duty and a fee for non-bank companies providing consumer loan services; (v) doubling real estate taxes; and (vi) increased excise duties and reduced duty-free allowances on certain products. Some measures – like increased dividend payout ratios for many state-owned enterprises and a reduction in pension contributions diverted to the second pillar – are, however, unlikely to lead to permanent reduction in the deficit. While bringing the headline deficit lower, diversion of second pillar pension contributions was not considered as part of the structural consolidation effort, as liabilities under the first pillar of the system are raised, and this measure is expected to be reversed in the coming years.

The expenditure side measures include (i) reduced staff and wage costs in the public administration; (ii) reduced appropriations relative to previous year's level in a number of areas, including health spending, social programmes, and defense spending; (iii) reduced subsidies for general education and financing for education innovation programmes; and (iv) cut in railway subsidies.

On top of these measures, there are two others which have not been counted against the consolidation needs, although leading to positive effects on the budgetary outcome and, possibly, higher revenues: these are measures for fighting the grey economy and halving of the Finance Minister's discretionary margin of 0.4% of GDP.

Overall, with the 2011 budgets, the government has taken few measures on the expenditure side, with **most of the adjustment coming from revenue side** (including the diversion of 2nd pillar pension contributions). While not ideal, this has to be seen against the fact that over the past two years the bulk of the cumulative adjustment has been on the expenditure side. In addition, the inflation aspect of some revenue-raising measures (like an increase in indirect taxes) called for their frontloading in 2011 to reduce their impact when assessing the inflation performance in coming years.

Concerning the 2012 budget, the government has taken a prudent approach, aiming at a deficit of 2.5% of GDP to reduce risks of missing the EDP requirements of bringing the deficit below 3% of GDP. The size of adjustment implied by this aim will be assessed in August/September when more macro and fiscal data are available; according to current estimates, the envisaged consolidation amount is considerable, though clearly smaller than in previous packages: 1.1-1.3% of GDP. Aiming for a target of well below 3% of GDP, as done by the government, is important as it would provide a safety margin against less favourable economic developments, but also against possible further bank restructuring costs[2]. Preparatory work is underway to identify a

[2] Costs related to Parex Banka negatively affected the general government outcome in 2009 and 2010; in 2010 this included, in addition to direct recapitalization costs, also expected losses on government deposits held in the bank, pursuant to the restructuring plan. It is thus unlikely that there

menu of options for measures to be included in the 2012 budget. Preparing such a menu of options by mid-August 2011, as stated in the new SMoU, will give the authorities a meaningful choice of measures once the final consolidation needs are assessed by end-August 2011 and will enable the government to submit the 2012 budget to Parliament for approval by the end of year.

For 2012, to improve revenue collection, the authorities are working on proposals to reform the property tax system, and also to partly reallocate personal income taxes paid to local governments to the state budget. Additional revenue potentially could be generated by better SOE and real estate management. The authorities are also working to implement a comprehensive strategy to strengthen tax administration and reduce the **grey economy (including illicit trade).** The EC/IMF teams have encouraged the authorities to allocate more and better technical and intellectual capacities in implementing the strategy for **fighting the grey economy**. Following SMoU conditionality, the authorities have prepared a list of ca. 60 measures for dealing with the grey economy in various sectors: some of the key measures are to be implemented from mid-2011 or January 2012. However, the revenue yield from grey economy is uncertain and hard to quantify and this justifies the prudence by the EC/IMF, which have convinced the Ministry of Finance to only consider a small part of such revenues in their consolidation effort. In order to assess the effectiveness of various measures, the authorities intend to set up a task force involving the programme partners, with the aim to report on expected yields in 2012 and beyond. The authorities also intend to revise the tax compliance strategy, taking into account the recommendations of an upcoming technical assistance mission from the IMF.

As regards expenditure cuts, the authorities are considering reducing the public sector wage bill and state subsidies, and reviewing options for rationalizing the system of social benefits and improving the sustainability of the pension system that is consistent with the long-term stability of the social security system, building, inter alia, on the recommendations of the World Bank public expenditure review and IMF technical assistance. The State Chancellery is undertaking functional audits to identify functions that can be abolished or performed more efficiently.

During the review mission, the EC team discussed with the World Bank, IMF and the authorities proposals on how to **improve and make permanent the social safety net and allocate sufficient resources for health and social expenditures in the 2012 budget and onwards**. There is a risk that once the Programme comes to an end, financing for implementing appropriate social safety net measures (health, apartment co-payments, pre-school teaching, transportation of kids to schools, social works, etc) will be scarcer. As regards active labour market policies, the conditions for **re-allocating additional financing within ESF or from ERDF/CF to ESF** for the 2011-2013 period have been preliminarily discussed.

Financial developments

Financial market conditions have continued to improve since the last review. The exchange rate of the lats has remained within the narrow fluctuation band to the euro without significant pressure on the foreign exchange reserves. Due to the mobilisation of programme funds to finance the budget, lats liquidity has become increasingly abundant over the second half of 2010. The growth rate of currency in circulation increased till October and stabilized at an annual pace of around 19% since then. The excess reserves accumulated by the banking system in the Bank of Latvia (BoL) approached LVL 1 billion by the end of 2010. On 15 July, the BoL reduced the interest rate on the 7-day deposit facility by 0.5 percentage points (to 0.5%) and lowered the interest rate on the overnight deposit by 0.125 percentage points (to 0.375%) with a view to encouraging commercial banks to start lending. From 24 November, the BoL lowered its deposit rates further to 0.375% and 0.25% respectively. Lats money market rates are stable and, up to the maturity of 3 months, they are below euro-area levels in 2011. Nevertheless, lending to households and corporates remains subdued both in domestic and in foreign currencies.

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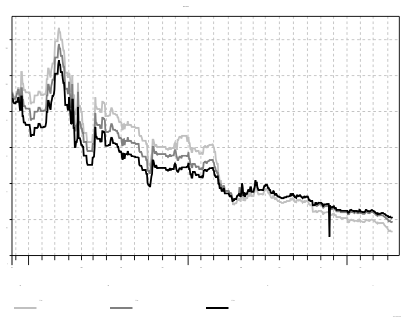
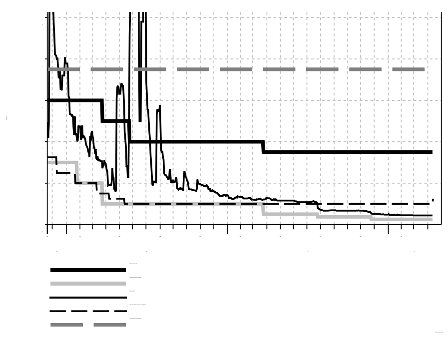
will be any additional impact in ESA95 terms for the government for operations undertaken in relation to Parex Banka, while minor impact is likely as concerns operations related to the MLB.

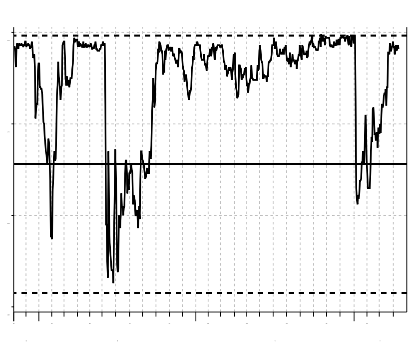
Treasury yields have declined and the maturity profile was extended since last summer. This was supported by improved confidence, ample lats liquidity and carefully managed supply. At the beginning of September, for the first time in two years, the Treasury successfully issued 5-year bonds to the domestic market, which was followed by another three issues in the autumn (the average yield of the last two auctions was around 4.3%). In the first quarter of 2011, the Treasury has also returned to the 10-year bond market with three small issues, selling them at a yield of around 6.7%. CDS spreads have steadily declined since the September 2010 parliamentary elections. In December 2010, S&P raised its credit rating for Latvia to BB+ and, in March 2011, Fitch upgraded the country to investment grade (Moody's already assigns investment grade to Latvia, although it is the lowest). Having two investment grade ratings is expected to open the way for Latvia to return to the international capital markets with a new bond issue.

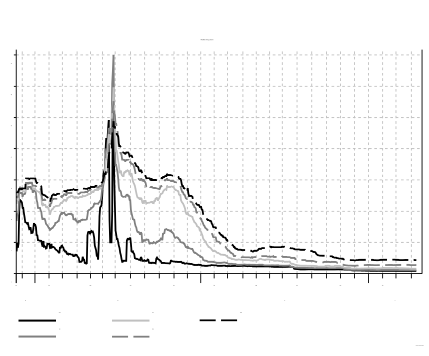
In early 2011, the Treasury has started to convert its foreign currency deposits to lats on the market, instead of transacting directly with the BoL. Despite advance communication, the shift of conversion practise led to a temporary strengthening of the lats in January, but it returned to the weak side of the band by the end of March, as the supply of foreign currency was reduced by the Treasury. There is also an increasing demand from households and corporates for foreign currency, fuelled by the recovering economy, rising energy prices and the need to service foreign currency-denominated debt. Foreign exchange reserves of the BoL declined from LVL 3.8bn at the end of 2010 to around LVL 3.4bn by the end of April, but international reserves covered more than 200% of the monetary base.

Developments in the banking sector are showing stabilization, though it may be too early to identify long-term trends. Based on end-of-February data, total loans have declined by 8% y-o-y. New lending, which reached LVL 1.1bn since July 2010, is still below amortization. 16 banks, which represent around 60% of market share, are planning to extend their loan book. The increase in loans to non-residents is a new phenomenon. This is not related to business in Russia, but to re-registration of Latvian companies under non-resident jurisdictions with the purpose of tax optimization. Deposits have been growing, up 14% on a yearly basis, mostly due to corporates. The rate of non-performing loans has stabilized, and even declined slightly. However, delinquencies in consumer loans are a new phenomenon since January 2011. One fifth of total loan portfolio has been restructured, with a provisioning rate at 14.4%. Loans in work-out reached almost 16%, with a provisioning rate of 44%. Overall banks are well capitalized, with total capital in the system at LVL 1.9bn. Banks have returned to profitability since the beginning of 2011. Two main factors are explaining this development. First, banks are reversing some of their provisions. According to the supervisor, this is well justified, as banks have over-provisioned in the past. Second, interest rates on loans to non-residents have been historically much higher, thereby generating a higher interest margin in the current circumstances.









<u>**Assessment of compliance with the third SMoU conditions**</u>

Based on the EC team's assessment, the specific economic policy criteria of the third SMoU can be considered broadly fulfilled. In particular, this conclusion reflects adoption of **the 2011 budget** by the Parliament in December 2010 and of the supplementary budget adopted in April 2011, as well as key measures taken in the area of financial and structural reforms (see budgetary developments). As regards **fiscal governance reforms**, the authorities have not yet finalized and submitted to the Parliament the new Fiscal Responsibility Law. However, this delay proves useful to wait for the final decisions on the EU directive on the new fiscal framework in order to ensure full consistency of the Fiscal Responsibility Law with it. Nevertheless, progress should be achieved within a year, so that it is fully in place by the next cycle, after the BoP programme expires. In that context, it may be useful to revise the mid-term budgetary framework to ensure consistency of its timetable and procedures with the new EU semester.

In other sectors, **the public sector unified wage grid** has been expanded with new groups, and the work on creating a comprehensive remuneration data base continues, although the wage bands remain large. There has been little progress in strengthening the elements of **career development** and annual official and employee assessment based on competences and performance, although there are improvements in **performance-based remuneration** (during 2011 each institution can pay up to 30% in bonus for max 10% of the best-performers within the set budgets).

The **restructuring processes of Parex/Citadele** are well advanced. For Parex/Citadele, the strategy for the work-out and sale of the banks was adopted by the Cabinet of Ministers on 17 May 2011, taking into account possible market interest, state aid-related issues, as well as other considerations (EBRD position). **The MLB restructuring plan** was after repeated delays submitted to the European Commission on 15 April (one of the pre-conditions for a partial release of the EUR 650m blocked account). A report on reviewing **development lending institutions** has been prepared, including recommendations on how to move towards a single development institution, which could strengthen synergies across existing institutions, and allow a more effective use of EU funds (currently channelled also via the JEREMIE facility of the EIF). Further steps are being considered among the involved ministries.

As regards structural reforms, the authorities have made good progress in **improving absorption of EU funds** (setting monthly spending targets to line ministries, involving banks in EU funds monitoring, etc), **reviewing public procurement procedures** (e.g., expanding the use of Electronic Procurement System, centralizing municipal procurements, pre-screening procurements, etc) and **streamlining efforts to attract new FDI** (inter-institutional working group under the PM). The special programme for the **support of small and micro companies** has been made operational (including micro tax), while a comprehensive plan to **fight the grey economy** and **combating illicit trade** has been adopted and is to be implemented (most significant measures like zero declaration, tax amnesty from July 2011). **A voucher system** for unemployed has been put in place, permitting a free choice of training, while improvements are being made in other ALMPs. The authorities should take more decisive steps as regards **the management of state owned enterprise and real estate policies**, as this has scope to generate significant revenues, while increasing the efficiency of the economy. In particular, progress in the course of 2011 could improve the potential for more revenues in 2012 and beyond.

Programme financing

Agreement was reached with the authorities to **treat the remaining two disbursements originally foreseen under the EU balance of payments support (both EUR 100m) as precautionary**. This reflects the relatively solid cash position of the Treasury and the possible issues on international markets that would be enabled by improved credit ratings. Progressive de-blocking of earmarked funds for the financial sector (see below) will further improve the financing position. The precautionary treatment of the last available tranches of the international financial assistance (including from the IMF) will neither affect the need to comply with conditionality nor the continuation of the regular joint review missions for the remainder of the programme period.

Given the overall stabilisation of the financial system reducing potential banking sector funding needs, **it was decided that money currently deposited in the sub-account for banking sector support at the Bank of Latvia shall be progressively released for the purpose of financing general government needs,** following formal approval by the Commission upon a request by the Finance Minister, in accordance with the following schedule (progress is to be assessed by the EC/IMF):

- EUR 300 m, on the basis of the submission to the Commission of the transformation plan for MLB in April 2011 and of the adoption of the sale strategy for Citadele and workout strategy for Parex in May 2011.
- EUR 100 m, on the basis of submission to the Commission of the sale strategy for MLB commercial segment.
- The remaining EUR 249 m are to be released on the basis of progress with the sale of Citadele and of the commercial assets and liabilities of MLB.

The authorities inquired about the possibility of **extending maturities** on the EU loans and the EC clearly explained that this is impossible. Besides the fact that current borrowing conditions are already very favourable, BoP assistance to Hungary and Romania was given with similar maturities and extending maturities would require a new programme. With stabilisation by and large successful, proper debt management should ensure a manageable reimbursement.

Post programme surveillance

Anticipating the formal expiration of the EU financial assistance programme in early 2012, the SMoU includes reference to the **post programme surveillance (PPS)** framework, which will subsequently apply to Latvia. Consultation with the authorities on the details of the PPS reporting framework would take place during the last review mission and would be agreed upon before expiration of the ongoing EU assistance programme. PPS, tailored to the EU surveillance framework, is closely equivalent to the Post-Programme Monitoring (PPM) framework used by the IMF to monitor policies after programme expiration in cases where outstanding IMF credit remains high.

Annex I: Latvia: financing contributions and profile, quarterly disbursements

Projected financing, millions euro	2008 Q4	2009 Q1/Q2	2009 Q3	2009 Q4	2010 Q1/Q2	2010 Q3	2010 Q4	2011 Q1	2011 Q2	2011 Q3	2011 Q4	Total
Total	**591**	**1 000**	**1 474**	**200**	**694**	**405**	**226**	**226**	**126**	**126**	**227**	**4 466**
EU		1 000	1 200		500		200					**2 900**
IMF /1	591		194		194	107						**1 086**
World Bank				200		100			100			**400**
EBRD			80									**80**
Nordics /2												*1 900*
Others /3												*300*

/1 Euro values change due to exchange rate effects

/2 DK, EE, FI, NO and SE; total EUR 1,900 m in credit facility arrangement

/3 CZ and PO; total EUR 300 m in credit facility arrangement

Annex II: The SMoU Conditions for the Fifth Installment

General Conditions

- The general government budget deficit targets for **2010-2012** in ESA95 terms are set at **no more than 8.5%, 6% and below 3% of GDP**.
- **All significant Cabinet decisions or other decisions with a fiscal impact**, including on social security or any guarantee scheme, **shall be announced and undertaken after discussions with the EC and the IMF**.
- **Any additional revenue or savings achieved relative to deficit targets should be used to achieve a lower-than-targeted budget deficit or**, after consultation with the EC and IMF, **to accelerate EU funds expenditure within the budgetary deficit targets set above or increase funding for active labour market and social safety net measures**. EU budgetary funding related to Structural funds and Cohesion Fund shall be used to the full extent and be budgeted appropriately. Appropriate technical assistance resources shall be ensured for the management and implementation of EU funds and other foreign financial assistance, in particular if their absorption is increased in 2010, and allocated to the respective Managing Authority, Audit Authority, Certifying Authority and the Intermediate Bodies.
- The Ministry of Finance's **macroeconomic forecasts** used as a basis for the budget preparation should be reviewed by the Bank of Latvia in consultation with external experts. The Commission services' forecast should be taken as a benchmark.

Specific Economic Conditions

	Fiscal consolidation	Fiscal governance	Financial sector	Structural reforms
July / August 2010		By end-July 2010, adopt a concept paper on **integrating the institutions involved in** management and planning of **human resources** within the public administration. **NOT COMPLETED**	**Continue facilitating market-based debt restructuring**, preparing a report by end-July 2010 on whether any legislative changes are necessary to further improve the tax treatment of restructured loans and foreclosure proceedings. **COMPLETED**	By end-August 2010, adopt the envisaged Cabinet of Ministers regulations **to exclude from procurement companies that are likely to operate in the grey economy**. **COMPLETED**
September / October 2010	After reviewing the social insurance benefit system by end-June 2010, submit to international lenders by end-September 2010 **concrete proposals aiming at streamlining the social insurance benefits system**, taking into account economic and demographic forecasts, so that appropriate changes can be **implemented after 2012**. **COMPLETED**: A RANGE OF OPTIONS WERE	**By end-September 2010, submit to the Parliament a new Fiscal Responsibility Law** complying with and supplementing the EU fiscal commitments and framework. **NOT COMPLETED** MULTIPLE DELAYS	By end-July 2010, appoint an independent consultant with a view to advise the government in preparing **a comprehensive transformation plan of the Mortgage and Land Bank** (MLB), to be submitted to the EC (DG COMP) by end-September 2010. **COMPLETED WITH A DELAY**	By end-September 2010, **finalize Riga and Pieriga Mobility Plan** in order to proceed with major Cohesion Fund projects. **COMPLETED** By end-September 2010, establish **a new unified position "Management of foreign financial instruments, including management of EU policies instruments"** in the job catalogue in view of providing better and more transparent remuneration conditions for the civil servants involved in EU funds

	PROPOSED AND PLAN TO BE IMPLEMENTED FROM JANUARY 2012 (CAPPING OF MATERNITY/PATERNITY BENEFITS, LIMITING SICKNESS BENEFITS, ETC. IN THE CONTEXT OF THE SUPPLEMENTARY 2011 BUDGET, THE GOVERNMENT EXTENDED MEASURES PREVIOUSLY TO EXPIRE BY END 2011)			management. **COMPLETED** By end-October 2010, in view of facilitating **bank lending for EU co-financed projects** and a more effective implementation of programme objectives, establish a regular involvement of commercial banks in the design of new EU co-financed programmes, as well as in the assessment of viability of EU projects before their approval by government agencies. **COMPLETED** THE BANKS ARE NOW REGULARLY INVITED TO EU STRUCTURAL FUNDS MONITORING COMMITTEES By end-September 2010, expand the list of goods and services covered by the **Electronic Procurement System (EPS)** and by end-November 2010 submit the necessary legal amendments to generalise the **mandatory application of the EPS** across all levels of government. By end-September 2010 publish **guidelines on centralizing municipal procurements** (and submit legal proposals by end-March 2011 to make them compulsory). **COMPLETED** By end-October 2010, adopt an overall plan to **fight the grey economy** with a view to implement it in 2011 and submit to the EC and IMF a comprehensive **action plan for combating illicit trade** and contraband, outlining appropriate measures and financing needs. **IN PROGRESS**

				PLAN TO IMPLEMENT MOST SIGNIFICANT MEASURES FROM JULY 2011/JANUARY 2012 By end-October 2010, in consultation with the EC and the IMF, make the special programme for **the support of small and micro companies** operational. **COMPLETED**
November / December 2010	By end-October 2010, **technical proposals producing savings or additional revenues**, based on structural reforms in key sectors, **for a total amount significantly larger than the fiscal consolidation needed in 2011 shall be submitted to the EC and IMF**. **COMPLETED** After preparing proposals for changes in the pensions system by end-June 2010, in consultation with the EC and the IMF, submit to the Parliament by end-November 2010 **concrete proposals to be implemented in 2011** in order to preserve future sustainability and adequacy of the three pillars of **the pension system**. **COMPLETED** THE AUTHORITIES PLAN TO FREEZE PENSIONS UNTIL 2013, ABOLISH SUPPLEMENTS TO PENSIONS FROM JANUARY 2012 AND START RAISING THE RETIREMENT AGE FROM 2016 ONWARDS	By end 2010, take necessary decisions to narrow further **public sector wage bands** supporting a more transparent and financially sound remuneration system and make sufficient progress with setting up a **general public sector remuneration database**, to allow closer reporting and monitoring. **IN PROGRESS** WHILE PUBLIC SECTOR UNIFIED WAGE GRID HAS BEEN EXPANDED WITH NEW ENTRIES, THE WAGE BANDS REMAIN LARGE; NOT CLEAR ABOUT THE REMUNERATION DATA BASE By end-2010, with technical assistance from international organizations, strengthen the following components of the **human resource management system**: (i) career development, (ii) system of annual official and employee assessment based on competences and performance. **NOT COMPLETED**	By end-December 2010, with advice from an independent consultant, develop **proposals for optimization of the system of development financial institutions** and integrate, as appropriate, different development institutions operating on behalf of the government. **IN PROGRESS**	By end-November 2010, **new guarantee products by the Latvian Guarantee Agency** shall be operational within the already allocated financing and in conformity with the Structural Funds regulations. **COMPLETED** By end-December 2010, update **the exit strategy from the ESF-financed emergency public works programme** with effective options for facilitating the participants' transition to regular employment, including providing opportunity for part-time training to the participants of the public works programme. **COMPLETED** FURTHER ASSESSMENT EXPECTED IN SPRING 2011 By end-2010, develop a **pre-screening programme of approving procurement decisions** by the Procurement Monitoring Office (PMO) beyond the EU co-financed projects, based on risk analysis, while appropriately strengthening the PMO capacities. **COMPLETED** ADDITIONAL STAFF FOR PUBLIC

	By end 2010, **complete the implementation of the September 2009 recommendations by the State Audit Office** regarding the assessment of implementation of the 2008 State budget and budgets of local governments to achieve additional public expenditure savings in 2010 and onwards. **IN PROGRESS**	By end 2010, submit to international lenders an assessment of options as regards possible restructurings, transformation into state agencies, or privatizations of part of **state and local government-owned companies and their subsidiaries**, against the criteria set in the Latvian State Administration Law. **COMPLETED WITH A DELAY**		PROCUREMENT OFFICE AND BROADER RANGE OF PRE-PROCUREMENT CHECKS By end-December 2010, in consultation with the EC and the IMF, **prepare a national investment attraction strategy** to focus on attraction and retention of both foreign and local investment. Under the auspices of the Prime Minister, establish a cross-sector, inter-institutional working group to propose specific measures to improve investment environment and follow up on the implementation of the strategy. **COMPLETED**
1st Q 2011		By end-March 2011 propose necessary changes in regulations to improve **performance-based remuneration**, thereby creating incentives for the most skilled public sector employees. In this context prepare regulations constraining the share of public employees who can receive the highest performance assessments. **COMPLETED** IN 2011 EACH INSTITUTIION CAN PAY UP TO 30% IN BONUS FOR MAX 10% OF THE BEST-PERFORMERS (WITHIN SET BUDGETS); THIS REMAINS TO BE SET IN A COMPREHENSIVE SYSTEM RELATED TO CAREER PROSPECTS		Take necessary steps to approve all the regulations for the ERDF (**OP Entrepreneurship and Innovation**) financing for the full period until 2013 and start signing project agreements by end-2010. **IN PROGRESS** **A voucher system** shall be in place by the 1st quarter of 2011, permitting a free choice of training, complemented by quality counselling and a structured evaluation system of the performance of training providers (based inter alia on placement indicators) to facilitate more informed decisions by the unemployed about available training programmes and among training providers. **COMPLETED**
Continuous			The FCMC will continue to ensure **close monitoring of the financial system** and **coordinate supervisory actions concerning cross-**	**Allocate sufficient budgetary resources for EU funded support, and demonstrate the achievement of efficient expenditure levels**. As a minimum, in **2011** Latvia should target

			border institutions. The FCMC, with the BoL, will ensure **monitoring of foreign banks' exposure** and share information with foreign supervisors and central banks and communicate its results to the EC and the IMF. **COMPLETED** The authorities, in consultation with the IMF and EC, will continue to **implement the restructuring plan for Parex Bank** once it is approved by the EC. **IN PROGRESS** SALES/WORK-OUT STRATEGY FOR CITADELE/PAREX HAS BEEN ADOPTED BY THE CABINET OF MINISTERS ON 17 MAY 2011	annual expenditure (paid by the intermediate bodies) of at least 72 m EUR from the ESF, 201 m EUR under the CF and 318 m EUR under the ERDF. **COMPLETED** HOWEVER, SUBSTANTIAL EU FUNDS WERE ADVANCED TO FINAL BENEFICIARIES, BUT NOT EFFECTIVELY ABSORBED IN 2010, SO STRICTER IMPLEMENTATION CONDITIONS ARE BEING PUT IN PLACE FROM MARCH 2011 FOR LINE MINISTRIES During 2010, further strengthen the **capacities of the State Employment Agency** to allow more efficient job counselling services through a lower number of unemployed per case-handler. **IN PROGRESS** SOME ADDITIONAL STAFF FINANCED BY EU FUNDS AND NEW TRAINING PROGRAMMES FOR SEA STAFF Take steps to **improve the business environment**, including by: a) making an inventory of **authorisations and permits** (registering property, operating a business and construction works) and propose a roadmap for simplification; b) with a view to introducing over the coming years **one-stop agencies at the regional level** providing front-office services, with back-office functions centralised and to the extent possible outsourced to private partners; c) ensuring **a wider application of e-governance services** and promoting the use of e-signature; **IN PROGRESS**